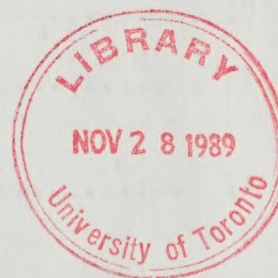


## Backgrounder

# THE FEDERAL DEFICIT AND UNIVERSALITY OF SOCIAL PROGRAMS

Marion G. Wrobel

ECONOMICS DIVISION  
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## THE FEDERAL DEFICIT AND UNIVERSALITY OF SOCIAL PROGRAMS

In the April 1989 federal budget, the Minister of Finance, the Honourable Michael H. Wilson, introduced a taxback mechanism for the family allowance and the old age pension. This paper examines the current federal deficit and the implications of various universally available programs and tax measures for the size of that deficit.

### THE NATURE OF THE PROBLEM

From the last half of 1982 to early 1985, the federal government was taking in only 72 cents for every dollar it spent. In the twelve month period from the fourth quarter of 1987 to the third quarter of 1988, the federal government took in 83.8 cents in revenue for every dollar it spent. This translated into an annual deficit of about \$21,358 million, which amounts to 3.65% of annual Gross Domestic Product (GDP). In 1970, and again in 1973 and 1974, the federal government had spent less than it received in revenues, but the corresponding fiscal surpluses were small when seen as percentages of GDP.

Figure 1 contains two series which present federal revenues as a ratio of expenditures. The bottom series, portrayed as a bar graph, represents revenues as a percentage of total expenditures, and it gives a broader portrayal of the picture described above. The upper series, shown as a line graph, represents the ratio of total revenues to program expenditures only; i.e., it ignores interest payments. That series shows quite clearly that the federal government is now taking in enough money to pay for its program spending. It is the interest payments on existing debt that are causing the overall deficit.

Such a situation is not unusual. In the first half of the 1970s, the federal government raised more revenue than it needed to pay for







programs, and the same was true in 1976 and 1981. The gap between the two series indicates the importance of interest payments in total expenditures.

Figure 2 presents an alternative method of examining the relationship between interest rates and the size of the deficit. This figure plots the deficit and interest payments as a percentage of GDP. The deficit measure follows a, sometimes very pronounced, cyclical pattern, whereas the interest payment series tends to have only slight cyclical variations.

Figure 2 also demonstrates clearly that interest payments are very high by modern standards and that their relative importance shows no sign of decline. The deficit, as a percentage of GDP, has been declining steadily for a number of years now.

Consider finally Figure 3. This also presents a variety of series expressed as a percentage of GDP. The two series at the top of the figure are total federal expenditures and total federal revenues. The vertical distance between these two series is the annual deficit as a percentage of GDP. Not only do these series show the evolution of the deficit over time, they also indicate whether the source of change is on the revenue or expenditure side. Figure 3 shows two quite distinct deficit episodes.

In the second quarter of 1974, total federal revenues had peaked at about 20% of GDP. Expenditures, while climbing, were only at 17.9% of GDP. The federal government therefore exhibited a substantial surplus in that quarter. After that, revenues declined substantially. In the three years 1978 to 1980, revenues varied between 15% and 16% of GDP. Expenditures, on the other hand, were varying between 19% and 20% of GDP.

By the third quarter of 1981, the deficit had fallen to about 1.6% of GDP, putting an end to this deficit episode. Where, however, do we lay the blame for these deficits? If our reference point is early 1975, when the budget was almost balanced for one quarter, with expenditures varying between 19% and 20% of GDP, it would appear that the growth of the deficit can be blamed on the substantial revenue decline to under 16% of GDP.

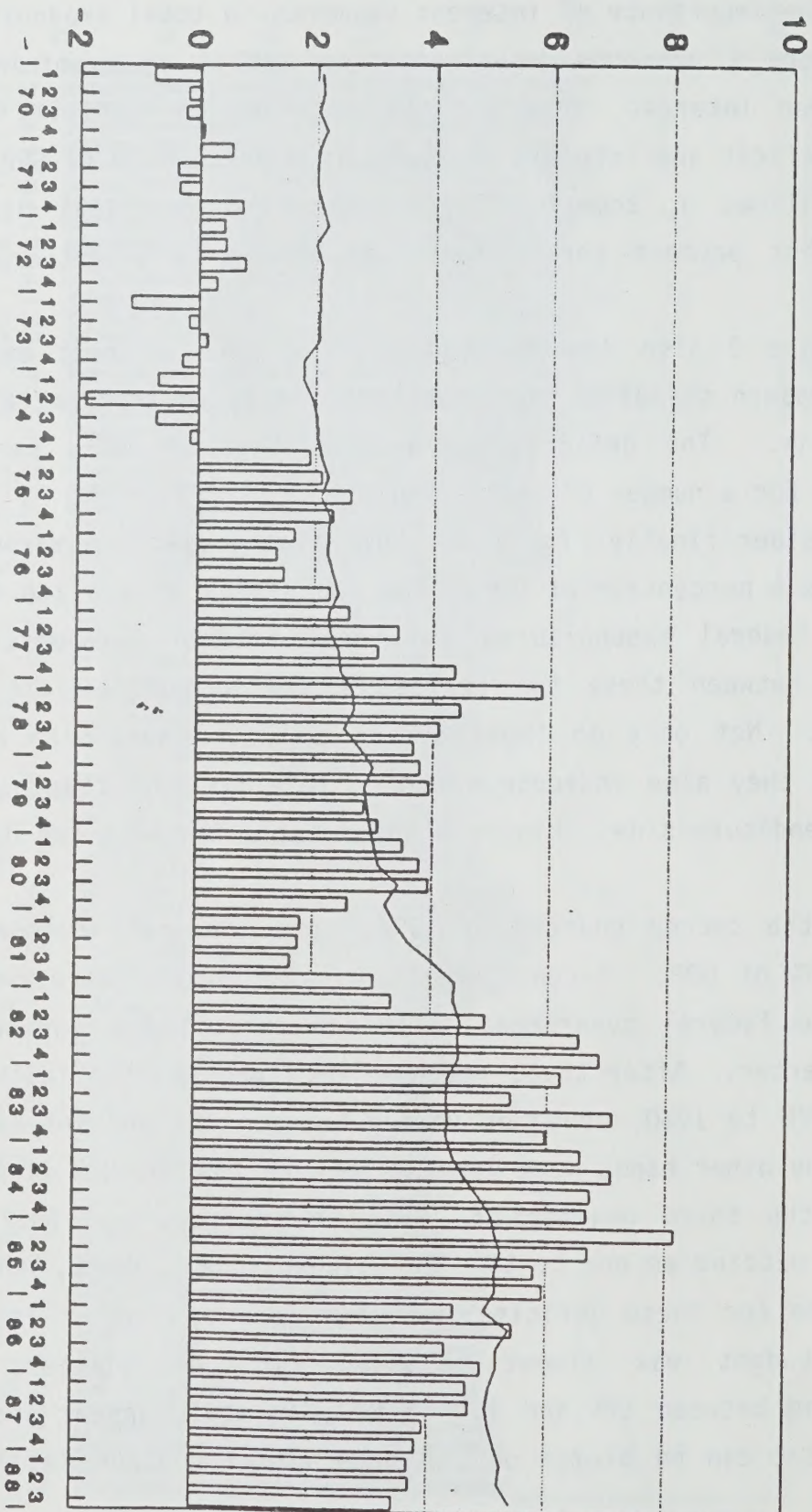
If we look to the start of these series in 1970, it is clear that the deficit episode is characterized by expenditures which are higher than in the early 1970s and revenues which are lower. From 1970 to



FIGURE 2

# FEDERAL BUDGETARY POSITION DEFICIT AND INTEREST COSTS

% OF GDP



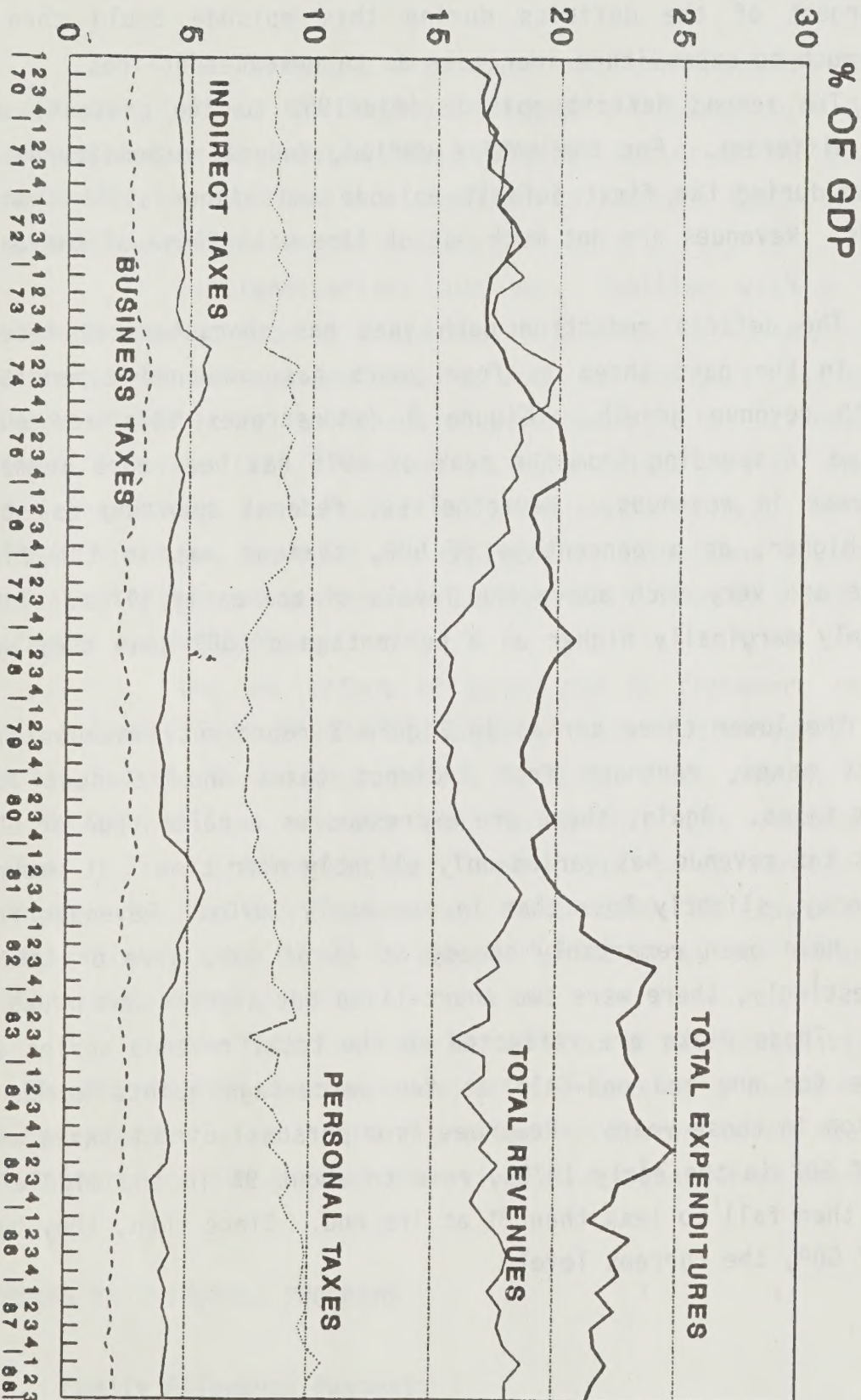
QUARTER AND YEAR

□ DEFICIT — INTEREST COSTS

NATIONAL ACCOUNTS BASIS



# FEDERAL BUDGETARY POSITION REVENUES AND EXPENDITURES



## QUARTER AND YEAR



the end of 1973, both revenues and expenditures averaged about 17.5% of GDP. The largest of the deficits during this episode could then be attributed as much to expenditure increases as to revenue declines.

The second deficit episode (mid-1981 to the present) was, and is, quite different. For the entire period, federal expenditures are far higher than during the first deficit episode and higher still than in the early 1970s. Revenues are not much out of line with those of the early 1970s.

The deficit reduction path that has characterized federal fiscal policy in the past three to four years has combined expenditure reductions with revenue growth. Figure 3 demonstrates this and shows that the decline in spending from the peak of 1975 has been more dramatic than the increase in revenues. Nevertheless, federal spending is still significantly higher, as a percentage of GDP, than it was in the first deficit episode and very much above the levels of the early 1970s. Total revenues are only marginally higher as a percentage of GDP than they were at that time.

The lower three series in Figure 3 represent revenues from business direct taxes, revenues from indirect taxes and revenues from personal direct taxes. Again, these are expressed as a percentage of GDP. Business direct tax revenue has varied only slightly over time. It amounts to 2% of GDP today, slightly less than in the early 1970s. Revenues from indirect taxes have been remarkably steady at 4% of GDP, give or take a little. Interestingly, there were two short-lived but significant peaks in 1974 and 1981. These peaks are reflected in the total revenue series and are responsible for one and one-half to two percentage points worth of deficit reduction in those years. Revenues from personal direct taxes were just over 8% of GDP in the early 1970s, rose to about 9% in the middle of the decade and then fall to less than 8% at its end. Since then, they have grown to 10% of GDP, the current level.



## **NATIONAL ACCOUNTS AND PUBLIC ACCOUNTS**

The foregoing discussion of federal expenditures, revenues and deficits follows the National Income and Expenditure Accounts. The government sector is treated like any other sector of the economy in these accounts and transactions are designed to measure their effect on income and expenditure flows in the economy.

Parliamentarians are more familiar with a discussion of government transactions as presented in the Public Accounts (PA). In that framework, transactions are measured and recorded on a cash basis. For the purposes of analyzing the impact of government on the economy, however, the National Accounts (NA) framework is more suitable. In the NA framework some transactions are treated on an accrual basis. As well, in the National Accounts, employer and employee contributions to employee pension plans are treated as government income, with pension benefits paid being treated as an expenditure.

The net effect of using the NA framework rather than the Public Accounts is to reduce the apparent size of the federal deficit. For example, for the fiscal year ending 31 March 1988, the PA federal deficit was \$28,000 million whereas the NA deficit was recorded as \$21,950 million. This difference was largely due to differences in recorded revenues under the two frameworks. Since 1980, NA expenditures have been slightly higher than those in the Public Accounts and revenues have been substantially higher.

The fact that the NA deficit is now substantially less than the PA deficit does not make the deficit less of a concern. The deficit can be regarded as a serious problem no matter which measure is used. What matters are the changes over time of any consistent measurement.

## **SPENDING ON UNIVERSAL PROGRAMS**

### **A. Family Allowance Payments**

In 1988, the federal family allowance program delivered \$32.38 per child per month; there were 6.6 million children under the age

of 18 years. (The actual monthly payment in Alberta and Quebec was based on a different formula, but averaged \$32.38 per child per month.) Total gross payments for fiscal year 1987-88 are expected to be \$2,562 million. Family allowance cheques are delivered to all eligible families regardless of income. These benefits are taxable, however; accordingly, part should be recouped through the income tax system. The net cost to the federal government until now has been about \$2,000 million.

## **B. Refundable Child Tax Credits**

In 1988, the federal government offered a refundable child tax credit (CTC) to families with children under the age of 18 years. The maximum value of the credit for 1988 was \$559 per child. The actual amount received was equal to \$559, multiplied by the number of eligible children, less 5% of family net income in excess of \$24,090. The Canadian Tax Foundation (CTF) estimates that this program cost the federal government \$1,450 million in 1987-88.

The population of eligible children is essentially the same as that eligible for family allowance. If there were no tax back mechanism applied to this \$559 maximum payment, the total cost of the program would be \$3,685 million, two and one-half times the actual amount.

## **C. Old Age Security**

Three programs for seniors constitute what we usually think of as the old age security system.

### **1. Old Age Pensions**

Anyone 65 years of age and older who meets the residency requirements is eligible for an old age pension. This pension is provided universally, but is subject to income tax. In 1988, the basic monthly pension was \$310.66 per person; in March 1987, 2.75 million persons received the pension. For fiscal 1987-88, it is estimated that the program cost \$10,321 million.



## **2. Guaranteed Income Supplement**

Those eligible for the old age pension (OAP) are also eligible for the Guaranteed Income Supplement, in part or in whole, if they meet certain income tests. A single pensioner might receive a supplement of \$369.21 per month, while a pensioner couple might receive a supplement of \$480.94 per month. The amount of supplement that a single pensioner actually receives declines by \$0.50 for every dollar of non-OAP income; the amount each one of a pensioner couple receives declines by \$0.25 for every dollar of non-OAP income. In 1988, a single pensioner would cease being eligible for any supplement once annual income reached \$12,250, while a pensioner couple would cease being eligible once family income reached \$18,500.

In March 1987, 1.35 million pensioners received the GIS, 49% of all pensioners, with the average monthly payment being \$219.50. In 1987-88 this program is estimated to cost the federal government \$3,678 million. These receipts are not taxable.

## **3. Spouse's Allowance**

The spouse (aged 60 to 64 years) of a recipient of the old age pension is eligible for an allowance as long as the family meets an income test. The maximum monthly payment for the spouse is equal to one-half the old age pension plus the maximum married GIS. This allowance is reduced according to family income: \$0.75 per dollar of income until the pension part of the allowance is eliminated and \$0.25 per dollar of income for the GIS portion of the allowance.

In fiscal year 1987-88, this allowance is expected to cost \$498 million. In January 1988 the maximum allowance was \$551.13 and 160,000 recipients are expected. Like the Guaranteed Income Supplement, these receipts are not taxable.

## **REMOVING UNIVERSALITY**

Of the total old age security payments of \$14,497 million in 1987-88, \$10,321 million (71.2%) was universally available. The OAP is taxable, so we can speak of 66% of the net cost of these programs being

delivered universally. Of the \$15,800 million net federal spending on all programs described above, 65% was delivered universally. Thus, spending could be reduced if payments were made more selective. Some experiments will now be described which determine the likely savings to the federal government of a removal of universality.

#### **A. Family Allowance Payments**

All families with children under the age of 18 years receive a family allowance cheque. These receipts are taxable, based on the income of the higher-income parent. The after-tax value to the family of this allowance varies inversely with income, and depends upon the joint federal-provincial marginal tax rate which applies to the higher-income parent. The cost to the federal government depends solely on the federal tax rate which applies to that parent. Until the latest budget, every family has received some net benefit.

One possibility would be to convert this family allowance payment into an enhanced refundable CTC program. From the point of view of the federal government such a move would have the advantage of transferring the provincial tax revenues from the family allowance to parents or the federal treasury.

What would happen if the family allowance payment, \$32.38 per child per month in January 1988, were to be added to the maximum CTC payment and taxed back according to criteria that now apply to the existing CTC? The poorest of families would be no worse off. They have no taxable income and receive the full benefits of the existing family allowance. Under an enhanced CTC, they would also receive the full benefit as long as family net income was no greater than \$24,090.

We do not have the necessary information to determine the impact of such a change for 1988. Taxation statistics for 1986 are available, however, so that we can calculate the effect of such a move, had it been put in place for the 1986 taxation year.

In 1986, family allowance payments averaged \$31.65 per child per month and the maximum CTC payment was \$454 per child per year, reduced by \$0.05 for every dollar of family net income in excess of \$23,500. In



the experiment, all families with a net family income less than \$23,500 would receive the entire CTC supplement of \$380. For other families, the supplement would be reduced by \$0.10 for every dollar of family net income in excess of \$23,500. The basic CTC would be delivered, as before, but the supplement would be subject to its own tax back regime.\*

A family with one child would cease receiving any CTC supplement once family net income reached \$27,300: that family would continue receiving at least some basic CTC, however, until family net income reached \$32,580. For a family with two children, the cutoff value of family net income for this supplement is \$31,100, for a family with three children, \$34,900 etc.

It is estimated here that a CTC supplement as described above would have cost the federal government \$1,156 million in 1986, compared to the family allowance program which cost \$2,500 million in gross terms and about \$2,000 million in net terms. This would have represented a savings of about 42%. Unlike the existing family allowance, the benefits of such a supplement would be highly targeted to poor families and lower middle class families with children.

## **B. Old Age Pensions**

The old age security system contains three components, two of which are delivered on the basis of an income test. Most of the system expenditures are delivered universally. The following describes the an experiment, also based on 1986 taxation statistics, in which the old age pension is made subject to an income test.

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\* It might be preferable to simply add the \$380 to the basic CTC program and use the existing tax back regime. The use of a supplement scheme here is used because of data limitations. Revenue Canada taxation statistics provide a breakdown of existing CTC recipients by family net income. Adding the \$380 to the basic CTC would increase the cutoff income levels for families and increase the number of families in the program. We do not have the data on income distribution of families who would be drawn into the program and therefore cannot determine the cost of such a program. The supplement variant is used here, not because it is a better approach, it might not be. Rather, it is used because of the date base at our disposal.

Revenue Canada's taxation statistics provide a breakdown of taxfilers by age and income category. Since the concern here is with recipients of the old age pension, we can limit our examination to filers 65 years of age and older. When using taxation statistics to examine families receiving the Child Tax Credit, we had a very good data base, since families must file tax returns to receive that credit and the takeup rate is very high. Pensioners receiving the OAP, however, might not file returns if their income was so low that they had no tax liabilities; filing a return is not a precondition for receipt of the OAP. As a consequence, taxation statistics represent an incomplete data base. Revenue Canada's taxation statistics indicate that 1.85 million returns were filed by persons 65 years of age or older, whereas the number of recipients of the OAP was closer to 2.7 million for that year.

It is still possible, however, that a valid experiment can be conducted. We would be concerned here with removing the OAP from higher income seniors only, and it is very likely that those persons do file tax returns. The lack of data is for low income pensioners and they would not be part of this experiment.

the experiment examines the savings from the OAP if the pension were to be limited to persons earning less than a certain level of income. Since OAP receipts are taxable, part of any reduction in benefits would simply result in lower tax revenues to both the federal and provincial governments. The net savings in federal government spending from a variety of cutoff levels would be as follows:

Cutoff Level	Federal Savings
\$20,000	\$1,254 million
\$25,000	\$ 859 million
\$30,000	\$ 612 million
\$35,000	\$ 441 million
\$40,000	\$ 333 million
\$45,000	\$ 260 million

All these results should be put in the context of a 1986 OAP gross cost of about \$8,900 million.

Although total spending on two universal programs, the family allowance and the old age pension, is very high, the savings from



the removal of universality would in fact be quite small, from \$1,100 million to \$2,098 million.

The savings from the removal of universality obviously depend upon the cutoff points chosen. In the case of the family allowance, the experiment used the 1986 turning point for the Child Tax Credit, \$23,500, and a taxback rate of \$0.10 per dollar of other income. In the OAP experiment, a reduction in the cutoff level from \$45,000 to \$25,000 would add only about \$600 million in annual savings. A further reduction of the cutoff point, to \$20,000, would add almost another \$400 million to federal savings.

The reason for these results is straightforward. High cutoff points withdraw the OAP from a small number of recipients. At a cutoff of \$45,000, only 100,000 recipients of the OAP would lose benefits. At a cutoff \$25,000 this number would increase to 341,000; it would increase again, to almost 500,000, with a \$20,000 cutoff.

Seniors tend to have lower incomes than the population as a whole; this is because most of them have retired. Seniors do tend to have relatively large amounts of investment income, much of which, however, does not show up as money income. Seniors also have large amounts of accumulated savings, part of which represents high degrees of equity in their homes, and the value of this equity does not show up as money income. There might, then, be some justification for using a lower income cutoff point for the OAP than for a revised family allowance or Child Tax Credit supplement.

In any event, we calculate that changes to the universal delivery of these two social programs would have only a small effect on the measured deficit of the federal government. Other kinds of expenditure cuts are needed to alleviate the problem.

## **INCOME TAX EXEMPTIONS, DEDUCTIONS AND CREDITS**

Taxpayers who have personal income tax liabilities are able to take advantage of a variety of measures to reduce their average tax rates. These measures include the personal exemption, the married and

equivalent to married exemption and the exemptions for dependent children. All of these were designed to ensure that low-income persons and families pay no tax and to introduce a measure of horizontal and vertical equity into the tax system.

The basic personal exemption is a method by which the first \$x of income is excluded from taxation. Under a system of increasing marginal tax rates the dollar value of the exemption increases with income; while the value as a percentage of income tends to decline. In a sense, then, it adds a measure of vertical equity to the tax system.

Exemptions for dependants, whether spouses, children or other relatives, are designed to introduce a measure of horizontal equity to the tax system. These measures recognize that the composition and income of the family unit behind the taxfiler determine his or her economic position. Two persons with the same money income have very different abilities to pay tax if one supports a family while the other does not. This notion of horizontal equity is as important for rich taxpayers as it is for poor ones. As a consequence, these measures have been made available to all who are in a taxpaying position.

The recent reform of the federal income tax system converted these exemptions into credits that offset taxes otherwise owing. The reform measures in the United States have removed the benefits of such tax expenditures from higher income individuals. An experiment is discussed below, using unpublished Department of Finance data, which calculates how much additional revenue the federal government might gain from limiting the use of such credits. We will use cutoff levels of annual income of \$100,000, \$75,000, and \$50,000, the income categories used in the Department of Finance data.

#### Personal Exemption Credit

As of 1988, the basic personal exemption credit against federal taxes was \$1,020 per person. Savings to the federal government would be estimated to be: \$131 million if the cutoff was \$100,000; \$277 million if the cutoff level of income was \$75,000; and \$1,038 million if the cutoff was \$50,000 per year.



### Married Exemption

The married or equivalent credit in 1988 was \$850 per person, applied to federal taxes. Limiting these credits to those earning less than \$100,000, or \$75,000 or \$50,000 would save the federal government \$29 million, \$73 million, or \$308 million respectively.

### Dependants' Exemption

The federal credit for dependants under 18 years of age was \$65 per year for each of the first two, and \$130 for subsequent dependants. It was \$250 for infirm dependants over the age of 18 years. Limiting this credit to those earning less than \$100,000 would save the federal government \$4 million. The savings would be \$8 million with a \$75,000 limit and \$33 million with a \$50,000 limit.

### Age Exemption

A \$550 federal tax credit was available to all taxpayers aged 65 years and over. Limiting this credit to those earning less than \$100,000 would save the federal government \$11 million. The savings would be \$20 million with a \$75,000 limit and \$50 million with a \$50,000 limit.

In summary, then, these four credits together would generate the following savings to the federal government: \$175 million at a \$100,000 cutoff; \$378 million at a \$75,000 cutoff; and \$1,430 million at a \$50,000 cutoff.

### CONCLUDING REMARKS

Removing universality as the basis for delivering social programs could reduce the deficit. Limiting the delivery of old age pensions and family allowances in the ways described above could reduce the size of the federal deficit by as much as 10%. Limiting the use of tax credits to those earning \$50,000 per year or less would reduce the federal deficit by another 7% or so, with over two-thirds of this reduction coming

from restricting the use of the basic personal tax credit, formerly the basic personal exemption.

The debate on social policy and universally delivered benefits has so far concentrated mainly on the use of "targeting" as a means of delivering more benefits to poorer families. Within this context, the elimination of universality has proven to be very sensitive. Removing universality in order to reduce the deficit is likely to be at least as contentious. Moreover, it is far from being a complete solution to the deficit problem.

In the April 1989 federal budget, the Minister of Finance, the Honourable Michael H. Wilson, introduced a taxback mechanism for the family allowance and the old age pension. Once the newly introduced taxback mechanism for the family allowance and the old age pension is fully in place, these benefits will be reduced by 15% of taxfiler income in excess of \$50,000. As a result, some taxfilers will cease to enjoy any benefit from these programs. The delivery will continue to be universal, although the enjoyment of real net benefits will now be limited to certain families, on the basis of an income test.

The federal government estimates that this new repayment mechanism could recoup \$618 million in 1990 under a fully mature system, less the amount of federal tax hitherto payable on these receipts.





